

TITLE 18. FRANCHISE TAX BOARD

As required by section 11346.4 of the Government Code, this is notice that a public hearing has been scheduled to be held at 2:00 p.m., January 16, 2008, at 9646 Butterfield Way, Town Center, Golden State Room A, Sacramento, California, to consider adoption of amendments to sections 24411 and 25106.5-1 under Title 18 of the California Code of Regulations, pertaining to the ordering of dividends that are paid from income that has been included in a unitary combined report and from income that has not been included in a unitary combined report

An employee of the Franchise Tax Board will conduct the hearing. Thereafter, a report will be made to the three-member Franchise Tax Board for its consideration. Government Code section 15702, subdivision (b), provides for consideration by the three-member Board of any proposed regulatory action if any person makes such a request in writing. The three-member Board will consider the proposed amendments to the existing regulations and comments submitted with respect to those proposed amendments prior to acting upon it at one of its meetings.

Interested persons are invited to present comments, written or oral, concerning the proposed regulatory action. It is requested, but not required, that persons who make oral comments at the hearing also submit a written copy of their comments at the hearing.

WRITTEN COMMENT PERIOD

Written comments will be accepted until 5:00 p.m., January 16, 2008. All relevant matters presented will be considered before the proposed regulatory action is taken. Comments should be submitted to the agency officer named below.

AUTHORITY & REFERENCE

Section 19503 of the Revenue and Taxation Code authorizes the Franchise Tax Board to prescribe regulations necessary for the enforcement of Part 10 (commencing with section 17001), Part 10.2 (commencing with section 18401), Part 10.7 (commencing with section 21001) and Part 11 (commencing with section 23001) of the Revenue and Taxation Code. The proposed regulatory action interprets, implements, and makes specific sections 24411 and 25106.5 of the Revenue and Taxation Code.

INFORMATIVE DIGEST/PLAIN ENGLISH OVERVIEW

Dividends received by one member of a unitary combined reporting group (see California Code of Regulations, title 18, section 25106.5(b)(3)) that are paid by another member of a unitary combined reporting group from income that was included in the unitary group's combined report (see California Code of Regulations, title 18, section 25106.5(b)(1)) are eliminated entirely from the income of the dividend recipient. (See

Revenue and Taxation Code section 25106). Dividends received by members of a water's-edge group (see California Code of Regulations, title 18, section 24411(b)(3)) from their foreign affiliates that are not included in the water's-edge group are generally 75 percent deductible. (See Revenue and Taxation Code section 24411.) The existing regulations under California Code of Regulations, title 18, section 24411, contain examples of how dividends that are paid by a specific payor are to be treated when a portion of the dividend qualifies for elimination pursuant to Revenue and Taxation Code section 25106 and a portion qualifies for partial deduction pursuant to Revenue and Taxation Code section 24411.

Despite the rules implicit in the examples contained in California Code of Regulations, title 18, section 24411, on July 7, 2004, the First Appellate District Court of Appeal issued its opinion in Fujitsu It Holdings, Inc. v. Franchise Tax Board (2004) 120 Cal.App. 4th 459, wherein it essentially eschewed the rules implicit in the examples contained in California Code of Regulations, title 18, section 24411, and instead, analogized to rules that it believed were implicit in the examples contained in California Code of Regulations, title 18, section 25106.5-1.

On November 20, 2006, the California State Board of Equalization (SBE) published its decision in the Appeal of Apple Computer, Inc., Cal. St. Bd. of Equal., November 20, 2006, 2006-SBE-002 (*Apple*). The year involved in *Apple* was 1989, and the issue decided was the same issue decided in the Fujitsu case discussed in the prior paragraph. The SBE rejected the reasoning of the Court of Appeal in *Fujitsu* and relied upon the rules implicit in the existing regulations to find in favor of the Franchise Tax Board. In order to clarify the relationship between the two regulations and to conform to the decision in *Apple*, the Franchise Tax Board is proposing to amend California Code of Regulations, title 18, sections 24411 and 25106.5-1, in order to eliminate any further potential for the two regulations being misinterpreted and to eliminate any confusion occasioned by the different result of the decisions in *Fujitsu* and *Apple*.

With respect to Regulation section 24411, subsection (a), the amendment merely provides that a deduction pursuant to Revenue and Taxation Code section 24411 is not allowed if the dividend at issue can be deducted or eliminated under another section of the Revenue and Taxation Code.

The amendment in subsection (b) is merely a rewording of existing language in that subsection that provides that "qualifying dividends" can relate to dividends paid from income that has previously been included in a combined report.

The amendment in subsection (c)(1) is a rewording of existing language in the subsection that mirrors language contained in Revenue and Taxation Code section 24411.

The amendment in subsection (c)(2) is a rewording of existing language in the subsection. It essentially reiterates the rule contained in the amendment to subsection (a).

The amendment in subsection (e)(1) specifically incorporates Internal Revenue Code section 316 and explicitly provides that a dividend is considered to be paid proportionally from every source of income that gave rise to earnings and profit for the year and that the deductibility or elimination of the dividend will be based on a pro-rata rule.

The original version subsection (e)(2)(A) provides that dividends are paid out of earnings and profits on a last-in-first out basis. The amendment in subsection (e)(2)(A) now cites to Internal Revenue Code section 316 as authority that supports that proposition.

The amendment in subsection (e)(2)(B) merely reiterates that the portion of dividends paid from income that has been included in a combined report will be treated in accordance with the rule set forth in the amendment to subsection (e)(1).

The amendment in subsection (e)(3) merely provides the specific citation in the Revenue and Taxation Code wherein the concept of "Subpart F Income" is expounded upon.

The amendments in subsection (e)(4) contain a clarification and expansion of four separate fact patterns wherein dividends are received that have been paid from income that was included in a combined report and income that was not included in a combined report.

With respect to Regulation section 25106.5-1, subsection (b)(1)(A)4 expands the definition of an intercompany transaction **involving the transfer** of stock to provide that the distribution is eliminated pursuant to Revenue and Taxation Code section 25106, or results in a distribution in excess of basis that is treated in accordance with the rules included in subsection (f).

The amendments in subsection (f)(2) contain a clarification and expansion of two separate fact patterns wherein dividends are paid and received from members of the same combined reporting group, but the dividends have been paid from income that was included in a combined report and income that was not included in a combined report.

DISCLOSURES REGARDING THE PROPOSED REGULATORY ACTION

Mandate on local agencies and school districts: None.

Cost or savings to any state agency: None.

Cost to any local agency or school district which must be reimbursed under Part 7, commencing with Government Code section 17500, of Division 4: None.

Other non-discretionary cost or savings imposed upon local agencies: None.

Cost or savings in federal funding to the state: None.

Significant statewide adverse economic impact directly affecting business including the ability of California businesses to compete with businesses in other states: None.

Potential cost impact on private persons or businesses affected: The Franchise Tax Board is not aware of any cost impacts that a representative private person or business would necessarily incur in reasonable compliance with the proposed action.

Significant effect on the creation or elimination of jobs in the state: None.

Significant effect on the creation of new businesses or elimination of existing businesses within the state: None.

Significant effect on the expansion of businesses currently doing business within the state: None.

Effect on small business: The regulation is generally utilized by large multinational corporations and not small businesses.

Significant effect on housing costs: None.

CONSIDERATION OF ALTERNATIVES

In accordance with Government Code section 11346.5, subdivision (a)(13), the Board must determine that no alternative considered by it would be more effective in carrying out the purpose for which the action is proposed or would be as effective and less burdensome to affected private persons than the proposed regulatory action.

The proposed regulatory action pertains to corporate taxpayers and therefore does not affect private persons.

AVAILABILITY OF STATEMENT OF REASONS AND TEXT OF PROPOSED REGULATIONS

An initial statement of reasons has been prepared setting forth the facts upon which the proposed regulatory action is based. The statement includes the specific purpose of the proposed regulatory action and the factual basis for determining that the proposed regulatory action is necessary.

The express terms of the proposed text of the regulation and the initial statement of reasons and the rulemaking file are prepared and available upon request from the agency contact person named in this notice. When the final statement of reasons is

available, it can be obtained by contacting the agency officer named below, or by accessing the Franchise Tax Board's website mentioned below.

CHANGE OR MODIFICATION OF ACTIONS

The proposed regulatory action may be adopted by the three-member Franchise Tax Board after consideration of any comments received during the comment period.

The regulation may also be adopted with modifications if the changes are nonsubstantive or the resulting regulation is sufficiently related to the text made available to the public so that the public was adequately placed on notice that the regulation as modified could result from that originally proposed. The text of the regulation as modified will be made available to the public at least 15 days prior to the date on which the regulation is adopted. Requests for copies of any modified regulation should be sent to the attention of the agency officer named below.

ADDITIONAL COMMENTS

If you plan on attending or making an oral presentation at the regulation hearing, please contact the agency officer named below.

The hearing room is accessible to persons with physical disabilities. Any person planning to attend the hearing who is in need of a language interpreter or sign language assistance, should contact the officer named below at least two weeks prior to the hearing so that the services of an interpreter may be arranged.

CONTACT

All inquiries concerning this notice or the hearing should be directed to Colleen Berwick at the Franchise Tax Board, Legal Branch, P.O. Box 1720, Rancho Cordova, CA 95741-1720; Telephone (916) 845-3306; Fax (916) 845-3648; E-Mail: colleen_berwick@ftb.ca.gov. The notice, initial statement of reasons and express terms of the regulation are also available at the Franchise Tax Board's website at www.ftb.ca.gov.